

**ELIMINATION OF DOUBLE TAX BENEFITS
FOR MILITARY HOMEOWNERS**

The Congress of the United States
Congressional Budget Office

PREFACE

Military homeowners currently enjoy double tax benefits: tax-free housing allowances and deduction of mortgage interest and real estate taxes from income taxes. A recent Internal Revenue Service ruling (Revenue Ruling 83-3) disallowed similar double tax benefits to members of the clergy. This study, prepared at the request of the Senate Armed Services Committee, examines the budgetary and distributional effects of extending the ruling to cover military homeowners.

Subsequent to the completion of this study, the House passed a tax reform bill, H.R. 3838, that includes a provision nullifying Revenue Ruling 83-3. Tax reform currently awaits action by the Senate, which could review the effects of applying the ruling to military personnel. In accordance with CBO's mandate to provide objective and impartial analysis, this study offers no recommendations.

Marvin M. Smith of CBO's National Security Division prepared the study under the general supervision of Robert F. Hale and Neil M. Singer. The author gratefully acknowledges the special assistance of Jonathan Woodbury (formerly of CBO) and Elizabeth S. Sterman, both of the National Security Division. Kathleen O'Connell, Larry Ozanne, and Rosemarie Nielsen of CBO's Tax Analysis Division provided valuable cost estimates. The report also benefited from the technical support provided by David Cathcart, Jane Crotser, Michael Dove, Magge Lazanoff, Douglas McCormick, John Perigo, and David Pomeroy of the Department of Defense. (Outside assistance implies no responsibilities for the final product, which rests solely with CBO.) Patricia H. Johnston edited the manuscript, which Dorothy Pompei prepared for publication.

Rudolph G. Penner
Director

March 1986

CONTENTS

SUMMARY	xi
CHAPTER I	
THE CURRENT TAX TREATMENT OF MILITARY HOUSING ALLOWANCES, HOMEOWNERSHIP, AND POSSIBLE CHANGES	1
Recent Treasury Tax Ruling	2
Principal Issues	4
CHAPTER II	
ALTERNATIVE APPROACHES TO THE CURRENT TAX TREATMENT OF MILITARY HOMEOWNERS	9
Analytic Method and Key Assumptions	9
Effects of the Military Homeowners Tax Plan	10
Offsetting Career Losses	18
APPENDIX A	
ESTIMATION OF MORTGAGE INTEREST PAYMENTS AND REAL ESTATE TAXES FOR MILITARY HOMEOWNERS	25
APPENDIX B	
ESTIMATED CHANGES IN TAXES FOR MILITARY HOMEOWNERS	27
APPENDIX C	
DESCRIPTION OF ACOL MODEL AND ITS APPLICATION IN THIS STUDY	29

TABLE 1	PERCENT OF MILITARY PERSONNEL WHO OWN HOMES, BY SELECTED AREA AND PAY GRADE.	12
TABLE 2	REPRESENTATIVE HOMEOWNER TAX INCREASES IN FISCAL YEAR 1986 UNDER MILITARY HOMEOWNERS TAX PLAN, BY SELECTED AREA AND PAY GRADE.	13
TABLE 3	LONG-RUN EFFECTS OF MILITARY HOMEOWNERS TAX PLAN ON CAREER FORCE.	17
TABLE 4	ALTERNATIVE PAY RAISES TO OFFSET SOME OR ALL OF THE LONG-RUN EFFECTS OF MILITARY HOMEOWNERS TAX PLAN (MHTP) ON CAREER FORCE.	20
TABLE 5	BUDGETARY EFFECTS IN FISCAL YEAR 1986 OF ALTERNATIVE APPROACHES TO MILITARY HOMEOWNERS TAX PLAN (MHTP)	21

FIGURE 1	PERCENTAGE OF OFFICERS WHO OWN HOMES, BY PAY GRADE	14
FIGURE 2	PERCENTAGE OF ENLISTED PERSONNEL WHO OWN HOMES, BY PAY GRADE	14

SUMMARY

As part of their compensation, military personnel receive either free government housing or tax-free housing allowances to assist them in obtaining private housing. Under present tax treatment, military homeowners also are allowed to deduct the full amount of their mortgage interest and real estate taxes from their adjusted gross incomes in computing their income taxes, regardless of whether their tax-free housing allowances partially or fully cover such expenses. As a result of a recent Internal Revenue Service (IRS) ruling on similar benefits, attention has been drawn to these "double" tax benefits. In light of the possible loss of these benefits, senior military and civilian officials of the Department of Defense (DoD) have exerted efforts to retain them. At issue are the cost to the government of continuing the double tax benefits and the effect on service personnel of eliminating them.

The Treasury Department is considering--but has not yet proposed--an extension of Revenue Ruling 83-3 to military homeowners. This ruling disallows double tax benefits to members of the clergy who both own homes and receive tax-free housing allowances. Under such a change, which is referred to in this study as the "military homeowners tax plan" (MHTP), military personnel who own their homes would be allowed to deduct only the amount of mortgage interest and real estate taxes that exceeds the sum of their Basic Allowance for Quarters (BAQ) and Variable Housing Allowance (VHA), both of which are tax exempt elements of total military compensation. The decision on whether to extend the ruling to military personnel has been delayed by the Treasury until January 1, 1987. Meanwhile, the House has adopted a tax reform bill (H.R. 3838) with a provision that would overrule IRS Revenue Ruling 83-3. Tax reform will next be considered in the Senate which could reexamine the effect of the application of a Revenue Ruling similar to 83-3 on military homeowners.

CBO estimates that elimination of the double tax breaks would generate about \$290 million in net savings to the federal government in fiscal year 1986. Similar savings would be realized in future years. These and other findings in this study assume that, except for changes in the double tax benefits, current tax laws are continued.

EFFECTS OF THE MILITARY HOMEOWNERS TAX PLAN

The decrease in after-tax income of military homeowners resulting from the homeowners tax plan would differ by pay grade and location. Service homeowners in higher pay grades would incur larger after-tax income losses (stemming mostly from their higher tax brackets and larger allowances) than those in lower pay grades, while, within pay grades, the MHTP would be more costly to those stationed in areas where higher housing allowances are paid.

The homeowners tax change would also produce career force losses, but they would be modest. (Career personnel are defined here as those who have completed four or more years of military service.) CBO estimates that, 10 to 15 years after the potential change, the military services would have about 2,500 to 10,500 fewer members in the career force than under the current system. (The lower estimate accounts for the impact on current military homeowners only, while the upper estimate allows for the possible effect on present nonhomeowners who might anticipate owning a home in the future.) These losses, however, would represent only a 0.2 percent to 0.9 percent reduction in the career force. Losses would be modest because only about 22 percent of all military personnel in the continental United States own homes and because many of these owners are senior personnel whose willingness to remain in the military is only slightly affected by changes in annual compensation.

OPTIONS TO MITIGATE CAREER FORCE LOSSES

The Congress could avoid even modest career force losses while eliminating the double tax benefits by providing offsetting increases in basic pay or bonuses. This study examined three alternative plans designed to accomplish this. One plan would involve a raise in basic pay for all personnel (that is, across-the-board raises). The second option would provide targeted pay increases in enlisted pay grades E-5 and E-6 and in officer pay grades O-4 and O-5--the pay grades in which members' after-tax income would be among those reduced most sharply by the MHTP. The third option would provide targeted bonuses for enlisted personnel in hard-to-fill skills at the first- and second-term reenlistment points (about five and nine years of service, respectively).

CBO found that under any of the three options, modest raises would suffice to offset some or all of the MHTP's adverse long-run effects on the size of the career force (see Summary Table 1). These raises would also negate at least some of the budgetary savings from the MHTP. On balance, however, elimination of the double tax benefit could probably be achieved without any net career force losses while contributing modestly to federal deficit reduction (see Summary Table 2).

SUMMARY TABLE 1. PAY RAISES UNDER ALTERNATIVE PLANS TO OFFSET SOME OR ALL OF THE LONG-RUN FORCE MANNING EFFECTS

	<u>Incremental Raises to Offset Losses (in percents)</u>		
	MHTP with Raise for All <u>a/</u>	MHTP with Targeted Raises <u>b/</u>	MHTP with Targeted Bonuses <u>c/</u>
Career Force			
Enlisted			
Lower bound	0.15	0.30	0.25-2.10
Upper bound	0.70	1.60	1.25-14.00
Officer			
Lower bound	0.25	0.50	0.00
Upper bound	2.05	4.25	0.00

SOURCE: Congressional Budget Office.

- a. A raise in basic pay for all active-duty personnel.
- b. Targeted basic pay increases for all personnel in pay grades E-5 and E-6 and pay grades O-4 and O-5.
- c. Targeted bonuses for active-duty enlisted members at the first- and second-term reenlistment points.

SUMMARY TABLE 2. BUDGETARY IMPACT IN FISCAL YEAR 1986
OF ALTERNATIVE PLANS (In millions of dollars)

Option	Net Annual Savings (+)/Costs(-)	
	Lower Bound	Upper Bound
MHTP with No Offsetting Raise in Basic Pay	+ 290	+ 290
MHTP with Raise in Basic Pay for All <u>a/</u>	+ 207 <u>b/</u>	- 210 <u>b/</u>
MHTP with Targeted Raises <u>c/</u>	+ 233 <u>b/</u>	- 124 <u>b/</u>
MHTP with Targeted Bonuses <u>d/</u>	+ 274 <u>e/</u>	+ 191 <u>e/</u>

SOURCE: Congressional Budget Office.

- a. A 0.15 percent to 0.7 percent raise in basic pay for all enlisted personnel and a 0.25 percent to 2.05 percent raise for all officers.
- b. This figure reflects increases in both basic pay and retirement accrual costs.
- c. Targeted basic pay raises of 0.3 percent to 1.6 percent for pay grades E-5 and E-6 and 0.50 percent to 4.25 percent for pay grades O-4 and O-5.
- d. Targeted bonuses of 0.25 percent to 1.25 percent for active-duty enlisted personnel at five years of service and 2.1 percent to 14.0 percent at nine years of service.
- e. This figure reflects increases in basic pay only.

CHAPTER I

THE CURRENT TAX TREATMENT OF MILITARY HOUSING ALLOWANCES, HOMEOWNERSHIP, AND POSSIBLE CHANGES

As part of their government compensation, military personnel receive either free government housing or tax-free, cash housing allowances to assist them in obtaining private housing. Today, about 620,000, or 44 percent, of all military service members in the continental United States live in government housing. The rest receive allowances and either rent private housing (an estimated 34 percent) or own their own homes (an estimated 22 percent).

All those who rent or own their own homes receive Basic Allowance for Quarters (BAQ). ^{1/} First established in its current form in 1949, BAQ today ranges from \$137.50 a month for military personnel in pay grade E-1 (an Army private or Navy seaman recruit) to \$680.70 a month for those in pay grade O-10 (a general or admiral). Since 1981, those who own or rent homes in high-cost housing areas also receive additional cash allowances called Variable Housing Allowances (VHA). About 60 percent of all personnel in the continental United States receive VHA payments that, for a general or an admiral stationed in Los Angeles, California, for example, can amount to as much as \$440.65 a month. Thus, these high-ranking officers can receive as much as \$1,121.35 a month in housing allowances.

Together, these cash allowances will cost the government \$4.5 billion in fiscal year 1986. In addition, these allowances are exempt from federal income taxes. Moreover, under present tax treatment, uniformed service members who own homes are allowed to deduct the full amount of their mortgage interest and real estate taxes from their adjusted gross income, regardless of whether their tax-free allowances partially or fully cover such expenses. Thus, military homeowners receive "double" tax benefits: tax-free allowances and tax deductions. ^{2/}

-
1. Members who live in government quarters judged "substandard" also receive limited cash allowances.
 2. Mortgage interest and property taxes are costs of investing in housing. Allowing homeowners to deduct these costs is considered a tax benefit because homeowners exclude from tax much of the income received from the home (in the forms of rental income the homeowner could receive for the house and long-term capital gains). It should be noted that renters benefit from other provisions of the tax code that favor rental housing.

To eliminate this preferential treatment, the Congress could restructure the compensation system to make all housing allowances taxable while increasing pay rates, thus affecting renters as well as homeowners. Although seemingly an appealing alternative, such an option has been considered on several occasions and rejected in each instance. This approach was initially proposed by the First Quadrennial Review of Military Compensation in November 1967, in part as a response to its findings that the complex military compensation system confused service personnel to the extent that they consistently underestimated the value of their compensation. This underestimation could have influenced some members' decisions not to reenlist. The commission recommended that all allowances be treated as taxable income as part of a military salary system that would be based on grade and years of service but not differentiated by dependency status. The proposal, however, was eventually dismissed by the Department of Defense (DoD) as unworkable and too expensive.

The taxing of military allowances was considered again recently as part of the debate within the Administration on possible tax reform. It was included in the Department of Treasury's November 1984 tax reform plan, but was not proposed in the plan the Administration announced in May 1985. ^{3/}

RECENT TREASURY TAX RULING

Section 265 of the Internal Revenue Code of 1954 (as amended) disallows the deductibility of expenses that are covered by tax-free allowances. For many years, the Internal Revenue Service (IRS) allowed military homeowners, members of the clergy who received similar housing benefits, and others who financed their education with GI Bill or other tax-free educational funds to claim deductions based on expenses that were paid for with their tax-free allowances. In 1983, however, the IRS's Revenue Ruling 83-3 disallowed double tax benefits for members of the clergy who own homes and receive tax-free housing allowances and also disallowed deductions for educational expenses that are financed by GI Bill or other tax-free scholarships. ^{4/} The ruling, whose implementation has been

3. Department of the Treasury, *Tax Reform For Fairness, Simplicity, And Economic Growth* (November 1984), p. 47; and *The President's Tax Proposals to the Congress for Fairness, Growth, and Simplicity* (May 1985).

4. For details on the ruling, see Internal Revenue Service, Revenue Ruling 83-3, 1983-1 Cum. Bull.

delayed until 1987, did not extend to military homeowners, however. Thus, military homeowners who receive tax-free BAQ or VHA would be treated differently for tax purposes from their clerical counterparts. Press reports indicate that the Treasury, in an attempt to address this inconsistency, is considering extending the ruling to cover military homeowners as well. ^{5/} Although the Treasury has not yet made any recommendation, the extension of this revenue ruling to military homeowners will be referred to in this study as the "military homeowners tax plan" (MHTP).

Strong opposition by the Secretary of Defense and others has resulted in several postponements in the enforcement of the Treasury's ruling and its possible extension to military homeowners. ^{6/} The Treasury, initially, set January 1, 1985, as the enforcement date. It was later changed to January 1, 1986, and more recently delayed until January 1, 1987. Meanwhile, the House has passed a tax reform bill, H.R. 3838, with a provision nullifying Revenue Ruling 83-3. But the ruling could still be applied to military homeowners, depending on final action in the Congress.

Effects of the Military Homeowners Tax Plan

Because of varying housing situations, the military homeowners tax plan (MHTP) could have very different effects on the tax deductions of military homeowners. For example, a military member with a combined tax-free allowance (BAQ + VHA) of \$5,000 and mortgage interest and real estate taxes of \$4,000 is now allowed to deduct \$4,000 from his or her adjusted gross income under the current system. Under the MHTP, however, this service member would not be allowed any deduction since the deductible housing expenses are more than covered by tax-free allowances.

Slightly different circumstances, however, could produce other effects. For instance, a service homeowner with housing expenses of \$5,000 and a combined tax-free allowance of \$4,000 similarly is allowed to deduct the full \$5,000 from taxes under the current system. But under the MHTP, the member would be permitted a deduction of only \$1,000, the excess of housing costs over his or her tax-free housing allowances. Clearly, application of Ruling 83-3 to the military could substantially reduce and, in many cases, eliminate the tax deduction of mortgage interest and property taxes for military homeowners and hence cut their after-tax incomes.

5. Paul Smith, *Army Times*, October 22, 1984.

6. Ibid.

PRINCIPAL ISSUES

The potential change in the tax treatment of military homeowners raises a number of questions:

- o What would be the impact on members' willingness to remain in the military (military retention) and hence the readiness of U.S. forces?
- o Which members would be most affected?
- o How could the Congress offset any adverse effects?
- o What equity considerations might be involved?

This study estimates the effects that the tax plan for military homeowners could have on costs and retention and discusses other issues. The report also presents options the Congress could implement to offset any adverse effects on retention. The remainder of this chapter briefly discusses the budgetary effects and key force manning issues and also outlines what some see as inequities in current law and the effect of the MHTP on them.

Budgetary Effects

One possible rationale for the MHTP's potential change is to establish consistency in the tax treatment of expenses paid out of tax-exempt income. The implementation of the plan, however, would also have budgetary implications. Military homeowners would experience a loss in the amount of their income tax deductions and, as a consequence, a rise in their income taxes. In the aggregate, these changes could result in some overall reductions in the federal deficit.

CBO estimates that, under the MHTP, the tax deductions that military homeowners would lose in 1986 would generate approximately \$290 million in increased taxes or net savings to the government. These revenue increases would be smaller in future years if more people decided to rent homes or if the military proposed and received approval to build more government housing. On the other hand, future revenue increases could be higher if some of the assumptions made here did not hold (for example, if the MHTP induced an increase in outside income or in spouses' earnings). A

discussion of the assumptions and methodology underlying CBO's estimate is presented in Chapter II.

Force Manning Issues

The effect of the tax plan for military homeowners on the services' ability to meet manpower goals is at the center of the debate. Opponents of the plan's potential change maintain that its adoption would result in the loss of tens of thousands of highly trained career personnel and, thus, impair military readiness.^{7/} Moreover, they argue that the plan would adversely affect the morale of many service members who would remain, since homeownership would no longer be financially attractive to them and their quality of life would be reduced.

Force Manning. Implementation of the MHTP might prompt some military personnel to leave the service. Such career decisions by military personnel depend on the comparison between the entire compensation package available to them in the military and the total compensation they might expect to receive in the civilian work force. The benefits accruing to those members receiving double tax benefits from homeownership represent only one element of their overall military compensation. Even though the loss of these double benefits would negatively affect the attractiveness of military compensation to these service members, what remains in question is the effect of this loss on the service members' retention decisions.

Morale and the Quality of Life. The charge that the elimination of the double tax breaks would diminish homeownership and hence have deleterious effects on the morale of those service members who choose to remain in the military focuses on two general aspects of homeownership: its investment potential and the overall quality of life it affords in comparison with base housing or apartment living. Neither aspect, however, may have effects as severe as some argue.

Service members contend that the return on the investment in their homes is severely limited as a result of their frequent changes in duty

^{7/}*Charitable Contributions and Ministers' and Military Housing Deductions*, Hearings before the Subcommittee on Taxation and Debt Management of the Senate Committee on Finances, 98:2 (1984), p. 52.

stations. ^{8/} Buying and selling of homes at each duty location can become unprofitable because of repeated transaction costs: mortgage points, for-gone interest on equity, and closing costs. Perhaps the greatest financial hardship occurs, however, when the frequent moves compel the service member to enter or leave the housing market at inopportune times in terms of housing prices and interest rate levels.

Apart from financial considerations, many service members argue that adoption of the military homeownership tax change would preclude them from homeownership and, therefore, adversely affect their families' quality of life. ^{9/} To the extent that the value placed on homeownership is high, it is clear that the tax plan for military homeowners would be detrimental. But although it would tend to discourage homeownership, the MHTP would not necessarily affect service members' choices of living in government or private housing, and thus its impact on quality of life might be mitigated.

Distributional Issues

The military homeowners tax plan would affect different military personnel in widely varying ways, and these distributional effects are one important part of the debate. Such equity considerations concern not only the tax consequences of the MHTP on military homeowners in absolute terms, but also its relative effects vis-a-vis the tax treatment of others in the civilian and military communities.

Civilian versus Military. Under current tax treatment, military homeowners have a lower tax liability than civilian homeowners who are in the same economic position and have the same ability to pay tax. The tax plan for military homeowners would tend to promote equal tax treatment of economic equals. Service members might be deemed to qualify for special treatment because of the risks and rigors of military life (referred to as the "X-factor"), but the double tax benefits are too limited in their incidence (only 22 percent of military personnel are homeowners) to be justified on this score.

8. Statement of Sharon Shipe, Vice President For Legislative Affairs, National Military Family Association, before the Subcommittee on Taxation and Debt Management of the Senate Finance Committee, 98:2 (October 15, 1985).

9. Ibid.

Military Homeowners Versus Military Non-Homeowners. Because of the double tax benefits, service homeowners receive disproportionately greater after-tax compensation than military nonhomeowners. Consequently, adoption of the MHTP without any offsetting compensation to homeowners would increase equity within the military by equalizing the incomes of service homeowners and nonhomeowners.

Among homeowners, those in more senior pay grades receive disproportionate advantages from the double tax breaks because they receive larger allowances and are in higher tax brackets. Adoption of the military homeowners tax plan would also eliminate or mitigate this inequity.

